Emerging market portfolio globalization: The next big thing

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One of 2014's great investment surprises has been emerging markets equity performance. Notwithstanding negative news (from Ukraine to China, Turkey to Thailand) and record foreign investor outflows, MSCI EM equity is up 5% in the first half of the year in line with MSCI All Country World Index equity. Emerging market financial assets have been remarkably resilient; the question is why? The answer lies in the greatly underappreciated fact of emerging markets' domestic financial asset expansion.

A recent Boston Consulting Group report noted that from 2007 to 2011 assets under management rose at a 12% compound annual growth rate in Latin America and a 6% compound rate in emerging Asia vs. a flat result for North America and Europe combined. Analysis of this report together with figures from national authorities reveal that from 2002 to 2012, emerging market assets under management expanded by more than 150%, from roughly $2.5 trillion to $6.4 trillion, far exceeding developed market asset growth.

What's more, EM financial asset growth is set to accelerate in the years ahead driven by middle class expansion and wealth creation, coupled with maturing financial services industries. Ernst & Young LLP reports the middle class in emerging markets is poised to expand by roughly 3 billion people, or more than 40% of today's population, in the next 20 years. While it's hard to find data estimates for emerging markets AUM going out 20 years, PricewaterhouseCoopers LLP has forecast a doubling, to roughly $13 trillion, by 2020. So in less than 20 years, emerging market financial assets will have risen roughly fivefold, from $2.5 trillion in 2002.

This rising tide of middle-class wealth will accelerate the development of nascent mutual fund industries across emerging markets. World Bank figures indicate mutual fund assets as a percentage of gross domestic product for Turkey, Poland, China and India are all less than 5%. Mexico sports a less than 10% ratio. These levels are a far cry from more mature mutual fund industries in emerging nations such as South Africa and Brazil, with ratios of 30% and 46%, respectively, let alone the U.S. at 77% of GDP.

What comes next?

To date, the vast majority of EM financial assets have been invested domestically. Going forward however, a sea change in EM institutional asset allocation is likely that will lead to a globalization of emerging markets financial assets.

We foresee five factors that will underpin this allocation shift abroad:

- asset growth coupled with maturing pension and fund management industries;
- rising imbalance between asset base growth and domestic financial market capacity;

- increased domestic economic volatility;
- greater regulatory flexibility to invest abroad; and
- domestic financial asset volatility – across stocks, rates and currency.

The implications are significant. First, governments will have to work harder to convince domestic financial assets to stay home. Second, what has been a stabilizing factor for emerging markets over the past year might become a volatility factor as domestic money moves offshore. Third, understanding how, when and where these allocation shifts will occur can provide insight not only into fund flows and currency movements but also relative investment opportunities.

A recent trip to China illustrates the latter point. For the past 20 years, China was a maker and exporter of things. Over the next decade, China will become an exporter of capital. Its neighbors — think Australia and New Zealand with high yielding currencies — will most likely see significant and sustained capital inflows, suggesting an investment opportunity.

It's happening all over the world

In Latin America, Chile represents the possible, while Mexico and Brazil illustrate the opportunity set. Chile's pension fund assets invested abroad rose to 38% of total funds in 2012 from 16% in 2002, while over the same period total AUM rose to $162 billion from $36 billion. Put another way, Chile's investments abroad rose more than tenfold, to more than $60 billion from less than $6 billion. Similarly, Mexico's private pension funds have more than quadrupled their AUM in the past decade, to $145 billion in 2012 from $35 billion in 2002. Yet, data from the Organization for Economic Co-operation and Development suggest only 12% of pension assets are invested abroad vs. a regulatory limit of 20%.

Brazil is even more suggestive of a prospective sea change; with more than $1.1 trillion in institutional AUM, it is one of the world's largest financial asset pools. However, OECD data show a scant 0.1% of pension fund assets invested offshore vs. a recently expanded 10% legislative limit. Brazil's home bias is not limited to pension assets. According to ANBIMA, Brazil's association of financial and capital markets, institutional money managers have invested only 2% to 3% abroad. Now, 6% real rates have something to do with that, but recent discussions with Brazilian asset managers indicate a surging desire to invest abroad. Of course, risks to offshore allocations exist. Increased use of financial sanctions is one; rising protectionist tendencies in a low growth world is another.

Opportunities exist in Asia, the Middle East and Africa as well. In the Middle East, Turkish investors face increased political risk and an uncertain macroeconomic framework. Currently however, less than 1% of Turkish institutional assets are invested abroad even though there is no limit. In Eastern Europe, Poland reports that less than 1% of its pension fund assets are invested offshore versus a 5% limit that is in the process of being raised to 30%. In Thailand, another nation afflicted by political uncertainty, OECD pension fund data indicate an offshore allocation of 0.5% vs. a recently upgraded regulatory limit of roughly 40%. South Africa's pension system — Africa's largest — has less than 10% invested abroad vs. a statutory cap of 25%.

We believe the trend of EM portfolio globalization is just beginning and expect it to be a significant factor in shaping global capital markets over the coming decade. Investors, money managers and financial institutions alike should be preparing for just such a future. In our emerging markets country sample set, the average pension fund foreign investment regulatory limit stood around 30%, yet allocations average only 8.5%. Thus EM pension fund offshore allocations could double by 2020 to 17% and triple by 2025 to roughly 25%, and still be well within regulatory limits. In dollar terms, EM pension assets invested abroad could jump to roughly $2.2 trillion from $500 billion between 2012 and 2020. Now that's a trend worth watching.

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